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## Look Who's Talking: Defining the Scope of the Misappropriation Theory after *United States v. O'Hagan*

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# LOOK WHO'S TALKING: DEFINING THE SCOPE OF THE MISAPPROPRIATION THEORY AFTER *UNITED STATES v. O'HAGAN*

JANET E. KERR\* & TOR S. SWEENEY\*\*

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## *I. Introduction*

In an attempt to ensure the fairness of the securities markets at a time when more Americans than ever are investing,<sup>1</sup> the Supreme Court in *United States v.*

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1. See Donald Lambro, *American Dream's Bull Market*, WASH. TIMES (D.C.), June 30, 1997, at A14.

*O'Hagan*<sup>2</sup> endorsed the validity of the "misappropriation theory" of securities fraud liability<sup>3</sup> under Rule 10b-5<sup>4</sup> of the Securities Exchange Act.<sup>5</sup> Under the misappropriation theory, the government may criminally prosecute anyone who trades in securities for personal profit using material, nonpublic information, in breach of a fiduciary duty owed to the source of that information.<sup>6</sup> The six-to-three decision in favor of the misappropriation theory marks a departure from the hostility that the Supreme Court has shown toward securities litigation in recent years.<sup>7</sup> The decision has provided the Securities and Exchange Commission with a powerful tool for fighting the abuses of insider trading.<sup>8</sup>

*O'Hagan*, which involved a lawyer who misappropriated a client's material, nonpublic information from his law firm, was an ideal case for the government to take to the high Court to test the validity of the misappropriation theory.<sup>9</sup> The \$4.3 million profit James Herman O'Hagan realized<sup>10</sup> through his crime is indicative of

2. 117 S. Ct. 2199 (1997).

3. This Article will not address civil liability under the misappropriation theory. Instead, it will focus solely on criminal liability with respect to section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

4. 17 C.F.R. § 240.10b-5 (1997).

5. Securities Exchange Act of 1934 15 U.S.C. § 78a-78ll (1994 & Supp. I 1995). The scope of this Article is limited to the discussion of the *O'Hagan* Court's treatment of Rule 10b-5. Accordingly, this Article will not discuss the Court's decision regarding the application of Rule 14e-3, 17 C.F.R. § 240.14e-3(a) (1997), a rule established by the SEC to regulate trading when there is a tender offer.

6. See *O'Hagan*, 117 S. Ct. at 2207.

7. See generally *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (eliminating aider and abettor liability under section 10(b) for accountants, lawyers, and investment bankers); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) (reducing the time for filing implied private claims under section 10(b)); *Dirks v. SEC*, 463 U.S. 646 (1983) (dismissing a case involving an investment analyst who disseminated material, nonpublic information); *Chiarella v. United States*, 445 U.S. 222 (1980) (dismissing a case involving a printer who traded on material, nonpublic information).

8. See Brett D. Fromson, *Justices Spell Out Insider Trading: Any Misuse of Confidential Information Is Illegal*, *Supreme Court Rules*, WASH. POST. (D.C.), June 26, 1997, at C1. ("In the past decade, nearly half of the 40 to 45 insider trading cases brought by the SEC's enforcement division each year have been based in part on this legal [misappropriation] theory."); Telephone Interview with Arthur F. Mathews, Counsel of Record, Wilmer, Cutler & Pickering (July 7, 1997) (stating that the misappropriation theory is an important tool for both SEC injunctive and civil relief).

9. See Dominic Bencivenga, *The Right Set of Facts: O'Hagan Court Affirms SEC Rule-Making Power*, N.Y.L.J., Apr. 3, 1997, at 5 ("At least part of the government's victory is attributable to the fact the SEC and Justice Department appealed *O'Hagan*, a case involving a lawyer who should have known better, rather than the 1995 Fourth Circuit decision, *United States v. Bryan*, 58 F.3d 933 [(4th Cir. 1995)], which overturned the conviction of a West Virginia lottery commissioner that was based on the misappropriation theory."); Telephone Interview with Arthur F. Mathews, Counsel of Record, Wilmer, Cutler & Pickering (July 7, 1997) (stating that the Government waited for *O'Hagan* because it was such a strong case for them because O'Hagan was an attorney that had a clear duty to his client).

10. See *O'Hagan*, 117 S. Ct. at 2205 ("According to the indictment, O'Hagan used the profits he gained through this trading to conceal his previous embezzlement and conversion of unrelated client trust funds."); see also Holman W. Jenkins Jr., *Knowing Naughty Information From Nice*, WALL ST. J., July 22, 1997, at A15 ("Mr. O'Hagan was found to have cheated one client, the Mayo Clinic, by settling a malpractice case for \$25,000 but telling the Mayo the amount was \$225,000. He deposited the difference in his own account, later explaining he felt the other lawyer had let the Mayo off too lightly.").

the type of capitalization from fraud involving nonpublic information that the misappropriation theory is meant to target.<sup>11</sup> The Supreme Court's decision to uphold *O'Hagan's* lower court conviction based upon the misappropriation theory has left the country with a theory of 10b-5 liability which leaves open more questions than it answers.

One significant problem with the *O'Hagan* decision is that the test for liability is too broad.<sup>12</sup> By approving a test for Rule 10b-5 liability in which virtually any relationship can be a basis for liability, the Court has made it difficult for individuals to understand the legality of their actions. Additionally, by upholding the misappropriation theory, it appears that the Court is approving the various rationales for liability the lower courts have accepted. In particular, the liability of remote tippees under this rule leads to uncertain results. Although the decision settles the question between the circuits as to the validity of the theory, it does not address which relationships will be covered or how remote tippees are to be handled.

The purpose of securities laws is to protect the integrity of the market.<sup>13</sup> Ensuring that investors cannot trade without risk preserves that integrity. But the unclear standards of the misappropriation theory go beyond this purpose. Under the misappropriation theory, individuals who undertake trades that involve risk may face prosecution.<sup>14</sup> The result of the Court's endorsement of the misappropriation theory is that both risk-free traders, as well as those who take a risk, face criminal liability. Because *O'Hagan* provides little, if any, instruction with respect to this issue, it is anticipated that the Court will be faced with this issue in the near future. This Article suggests an alternative method of assessing liability under the misappropriation theory. If applied, this standard would more clearly define an individual's liability under section 10(b) and Rule 10b-5.

This article will examine the *O'Hagan* Court's opinion and the potential problems arising out of the application of this decision to section 10(b) and Rule 10b-5 liability. Part II looks at the evolution of 10b-5 liability including the history of the federal securities laws, as well as both the classical and misappropriation theories. Part III examines the history of insider trading and the development of the misappropriation theory through the different circuits. Part IV analyzes the *O'Hagan* decision and gives background to the Supreme Court's holding. Part V analyzes potential problems with the *O'Hagan* Court's holding and proposes a three-prong test for remedying the problems with the misappropriation theory.

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11. See *O'Hagan*, 117 S. Ct. at 2209 ("The misappropriation theory targets information of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities.").

12. See *supra* note 3.

13. See *O'Hagan*, 117 S. Ct. at 2209 ("The Exchange Act was enacted in part 'to ensure the maintenance of fair and honest markets,' 15 U.S.C. § 78b, and there is no question that fraudulent uses of confidential information fall within § 10(b)'s prohibition if the fraud is 'in connection with' a securities transaction.").

14. Even if a series of tipplers and tippees were trying to pass along accurate inside information, there is no guarantee that those communications would be accurate.

## II. The Evolution of 10b-5 Liability

### A. Rule 10b-5 Liability Under the Federal Securities Laws<sup>15</sup>

To combat the perceived abuses in the securities market which led to the stock market crash of 1929 and the depression of the 1930s, Congress enacted a number of regulatory laws aimed at promoting integrity and fairness in the securities industry.<sup>16</sup> Congress emphasized full disclosure of information to investors, which replaced the previous attitude of *caveat emptor*.<sup>17</sup> In addition, Congress created the Securities and Exchange Commission (SEC), a federal agency with the duty of carrying out those goals.<sup>18</sup>

The two most important regulatory laws are the Securities Act of 1933 (Securities Act)<sup>19</sup> and the Securities Exchange Act of 1934 (Exchange Act).<sup>20</sup> The Securities Act regulates an issuer's registration and information disclosure when securities are sold to the public. The Exchange Act governs the operation of securities trading. More specifically, the Securities Act was passed with the intention of preventing fraud and insufficient information in conjunction with an initial offer or sale of securities.<sup>21</sup> The Exchange Act, which has the same purpose, regulates securities trading and prohibits manipulation and fraud in the secondary market.<sup>22</sup> Section 10(b)<sup>23</sup> of the Exchange Act expressly "prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."<sup>24</sup>

In 1942, pursuant to the SEC's authority under section 10(b), the SEC promulgated Rule 10b-5.<sup>25</sup> This rule has since been expanded such that it has been termed

15. This section only discusses the statutory development of the federal securities laws. It will not address the case law with respect to this.

16. See *Central Bank of Denver, N.A., v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 170-71 (1994).

17. See *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972).

18. See 15 U.S.C. § 78(d) (1994 & Supp. I 1995).

19. 15 U.S.C. §§ 77a-77ll (1994 & Supp. I 1995).

20. 15 U.S.C. §§ 78a-78ll (1994 & Supp. I 1995).

21. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975).

22. See *id.*

23. Section 10(b) of the Exchange Act states the following:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1994).

24. See *Chiarella v. United States*, 445 U.S. 222, 225 (1980) (quoting 15 U.S.C. § 78(j) (1994)).

25. See *id.* Rule 10b-5 of the Exchange Act provides:

the "catch-all" provision for fraud.<sup>26</sup> Congress has not yet defined the term "insider trading,"<sup>27</sup> nor has it delineated when such types of trading are not permissible. As a result of the broad language of both section 10(b) and Rule 10b-5, different courts have applied one of two theories in the determination of liability for insider trading.<sup>28</sup> These two theories, termed the "classical" or "traditional" theory (hereinafter "classical theory") and the "misappropriation" theory, are the foundation of this Article. The *O'Hagan* decision ultimately settles the question as to the validity of the misappropriation theory.

### B. Case Law Defining the "Classical Theory" of Insider Trading

Under the classical theory, liability under Rule 10b-5 is based upon common law notions of fraud.<sup>29</sup> At common law, fraud can be found where there was silence regarding facts unavailable to another party and the silent party had a duty to speak arising out of a special relationship.<sup>30</sup> Under the classical theory, "insiders" have such a duty to speak. "Insiders" can be defined as directors, officers, or controlling shareholders<sup>31</sup> with access to material, nonpublic corporate information by virtue of their positions.<sup>32</sup>

This liability was extended to individuals other than corporate insiders in *In re Cady, Roberts & Co.*<sup>33</sup> This case involved the duties of a broker after receiving

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It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1997).

26. *Chiarella*, 445 U.S. at 234-35; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976).

27. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified at 15 U.S.C. § 78a (1994)). Congress has developed penalties for those involved in illegal insider trading. However, it has not drawn a distinct line with respect to the types of trading that can be considered illegal.

28. See *Chiarella*, 445 U.S. at 228-29; see also *United States v. O'Hagan*, 117 S. Ct. 2199, 2207 (1997) ("The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities.").

29. See Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 112-14 (1984) (discussing the influence of common law fraud in the development of Rule 10b-5).

30. See *Chiarella*, 445 U.S. at 230.

31. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961).

32. See *id.* at 913-14. The holding in this case is the genesis of the "disclose or abstain" rule. The SEC held that a partner in a securities firm who traded on nonpublic information willfully violated section 10(b) and Rule 10b-5. See *id.* The SEC held that the partner was an insider who took advantage of his access to corporate information and thus committed fraud on the person who sold him stock by not disclosing this information. See *id.*

33. 40 S.E.C. 907 (1961).

nonpublic information from a corporate director as to a company's dividend action.<sup>34</sup> The *Cady, Roberts* duty provided that any person enjoying a "relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose," is presumed to have a fiduciary relationship of trust and confidence with the shareholders.<sup>35</sup> A person in this type of relationship has a duty to disclose the confidential information prior to trading or to abstain from trading on this information altogether.<sup>36</sup> The court in *Cady, Roberts* deemed the broker to be an insider even though he was not a director, officer or controlling shareholder and reasoned that as an insider, the broker should have disclosed or abstained.<sup>37</sup>

The Second Circuit, in *SEC v. Texas Gulf Sulphur Co.*,<sup>38</sup> extended the "disclose or abstain rule" as defined by the *Cady, Roberts* court. In *Texas Gulf*, a number of directors and officers, as well as other insiders, of Texas Gulf Sulfur Co. obtained access to confidential information regarding certain drills the company had conducted in Canada.<sup>39</sup> These individuals, based on this confidential information, purchased the company's stock, as well as informed others without access to this information, who subsequently made trades themselves.<sup>40</sup> The court found the disclose or abstain rule as advocated by the court in *Cady, Roberts* to be valid and held that this duty arises under "those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if disclosed."<sup>41</sup> The court reasoned that unequal access to knowledge regarding important facts about a company's future would have a significant negative impact on the market.<sup>42</sup> The *Cady, Roberts* court found the nature of the information being traded upon, as opposed to how the information was obtained, to be most relevant.<sup>43</sup>

The nature of the relationships that give rise to a duty to disclose or abstain were defined in *Chiarella v. United States*,<sup>44</sup> a case that formed the foundation of insider trading under the classical theory. In *Chiarella*, the petitioner, a "markup man" at a printing company, was handling documents announcing corporate takeover bids and, despite the fact that the names of the target companies were concealed, he was able to deduce the names from other information contained in the documents.<sup>45</sup> The *Chiarella* Court narrowed the holding in *Cady, Roberts* to require a breach of

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34. See *id.* at 914.

35. *Id.* at 912.

36. See *id.*; *supra* note 32 and accompanying text.

37. See *Cady, Roberts*, 40 S.E.C. at 912.

38. 401 F.2d 833 (2d Cir. 1968) (en banc).

39. See *id.* at 839-40.

40. See *id.*

41. *Id.* at 848 (quoting Arthur Fleischer, Jr., *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1289 (1965)).

42. See *id.* at 852.

43. See *id.* at 849. To assess materiality, the *Texas Gulf* court held that one must look to whether a reasonable person would find the information to be important in making the determination of whether to purchase or sell securities in a company. See *id.*

44. 445 U.S. 222, 235 (1980).

45. See *id.* at 224.

a fiduciary duty or similar relationship of trust and confidence by a "person in whom the sellers had placed their trust and confidence" to support liability.<sup>46</sup> The Court found liable only those individuals who bought or sold securities on the basis of material, nonpublic information in breach of a duty to the shareholders of the corporation whose securities were being traded.<sup>47</sup> The Court stated that a duty to disclose or abstain does not arise from the mere possession of nonpublic information<sup>48</sup> and the Court limited this duty only to corporate insiders.<sup>49</sup> The markup man in *Chiarella*, who had no prior dealings nor any other relationship with the shareholders of the target corporation, therefore did not owe a duty to disclose or abstain and, accordingly, his trades did not constitute fraud.<sup>50</sup>

*Dirks v. SEC*<sup>51</sup> reaffirmed the holding in *Chiarella* with respect to the disclose or abstain rule, in addition to applying Rule 10b-5 in situations where tippees traded on material, nonpublic information.<sup>52</sup> Raymond Dirks, an officer of Delafield Childs Inc., was informed by a former officer of Bankers National, which had recently been acquired by Equity Funding of America, that Equity Funding had vastly overstated its assets.<sup>53</sup> The asset overstatement was a result of a number of fraudulent corporate practices.<sup>54</sup> Following this disclosure of information, Dirks flew to Los Angeles to investigate the situation.<sup>55</sup> Dirks remained in contact with investors and analysts, both in an attempt to uncover additional information and to notify both clients and potential clients of the situation.<sup>56</sup> Dirks also attempted to contact the *Wall Street Journal*. However, the Los Angeles bureau chief did not believe the story.<sup>57</sup> Before the New York Stock Exchange could halt trading on Equity Funding stock, several investors, as a result of speaking with Dirks, had already sold more than \$16 million of stock.<sup>58</sup> Despite Dirks' attempts to uncover and expose Equity Funding's fraud, the SEC charged and convicted him of violating the antifraud provisions of the securities laws.<sup>59</sup>

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46. *Id.* at 232 (stating that insiders have more access and greater knowledge with respect to the company for which they are employed, and thus must primarily take into consideration the welfare of these ordinary shareholder).

47. *See id.* at 233-35. The *Chiarella* Court appears to be limiting the standard established in *Cady, Roberts*. The rationale is that applying a broad duty between all participants in the securities market goes far beyond the standard established under the classical approach to Rule 10b-5, whereby a duty only arises from a specific relationship between two parties. *Id.*

48. *See id.* at 235.

49. *See id.* at 227-28. Corporate insider status is found where one has obtained confidential information by reason of a position within the corporation for which one is employed. *See id.* at 228.

50. *See id.* at 232.

51. 463 U.S. 646 (1983).

52. *See id.* at 653-54.

53. *See id.* at 648-49.

54. *See id.* at 649.

55. *See id.*

56. *See id.*

57. *See id.* at 649-50.

58. *See id.* at 649.

59. *See id.* at 650-51.



The *Dirks* Court acknowledged that the nature of the securities market, as well as information dealing with the market, leads to knowledge of certain information by some individuals that is not equally available to all the public generally.<sup>60</sup> The Court reasoned, however, that it would be virtually impossible for all traders to enjoy equal information regarding securities prior to trading in the securities markets.<sup>61</sup> Additionally, the Court pointed out that recipients of inside information do not invariably acquire a right to freely trade on material, nonpublic information.<sup>62</sup> In essence, a balance between the two was desired. The *Dirks* Court attempted to balance these dual interests by finding liability for tippees if the individual knew or should have known, based on the type of information, that the information received constituted a breach of the insider's fiduciary duty.<sup>63</sup>

According to the *Dirks* Court, an ordinary tippee has no independent fiduciary duty to the corporation and its shareholders.<sup>64</sup> The SEC based its theory of tippee liability on the notion that the antifraud provisions require equal information be available to all traders.<sup>65</sup> However, enforcing a rule whereby it is necessary to disclose or abstain following the receipt of any material, nonpublic information would serve to inhibit market analysts as well as the market itself.<sup>66</sup> A tippee violation can be interpreted as an indirect violation of the disclose or abstain rule set out in *Cady, Roberts* and upheld in *Chiarella*.<sup>67</sup>

Because *Dirks* was not given the information by another for his own personal benefit, *Dirks* did not inherit a fiduciary duty to the shareholders.<sup>68</sup> Although *Dirks* was not found liable, the *Dirks* decision served to expand the scope of insider liability to tippees who facilitated a fraud through a failure to disclose or abstain after an insider breached a fiduciary duty through the disclosure of the information

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60. *See id.* at 659.

61. *See id.* at 657.

62. *See id.*

63. *See id.* at 660. In explaining the role of tippees with respect to Rule 10b-5 liability, the Court stated that "some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them improperly." *Id.*

64. *See id.* at 655 & n.14. The Court did not find an independent fiduciary duty for tippees like that applied to insiders. Although information legitimately revealed to an underwriter, accountant, lawyer, or consultant working for the corporation does not give rise to an insider relationship, these outsiders may be deemed fiduciaries of the shareholders, thereby the status of "insider" may be imputed upon these outsiders. This duty applies where the outsider has entered into a special confidential relationship giving access to material, nonpublic information while working for the corporation. *See id.*

65. *See id.* at 657. The Court in *Chiarella* noted that the formulation of a rule whereby everyone would be privy to all information equally would not be appropriate absent explicit evidence of such intent by Congress. *See Chiarella v. United States*, 445 U.S. 222, 233 (1980).

66. *See Dirks*, 463 U.S. at 658.

67. *See id.* at 661 (citing *In re Investors Mgmt. Co.*, 44 S.E.C. 633, 651 (1971) ("[T]ippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information . . .")).

68. *See id.* at 666-67.

to the tippee, and the tippee knew or should have known that there has been a breach.<sup>69</sup>

The holdings in *Chiarella* and *Dirks* further defined liability under Rule 10b-5, effectively rounding off some of the rough edges formed as a result of the broad language in both section 10(b) and Rule 10b-5. To summarize, the classical theory, as interpreted by the Supreme Court, did not allow for a finding of liability for insider trading under Rule 10b-5 unless the individual owed a fiduciary duty to the corporation and its shareholders.<sup>70</sup> The *Dirks* Court, in an attempt to enforce the purpose of Rule 10b-5, expanded this limited application of fiduciary duties to validate the imposition of liability upon a tippee who received information from an insider in a corporation and knew or should have known that by disclosing the information the tipper was breaching a fiduciary duty.<sup>71</sup>

Both *Chiarella* and *Dirks* served to expand the limits of insider trading liability under the classical theory of Rule 10b-5. Additionally, these two cases form the basis upon which the misappropriation theory rests. Chief Justice Burger's dissenting opinion in *Chiarella*, first suggested the need for expansion of the classical theory. *Dirks* pioneered this expansion by extending liability under the disclose or abstain rule to tippees of insiders. Based upon these two cases and the SEC's goal of protecting investors, the misappropriation theory has since been addressed by a number of the circuits.

### *III. History of the Misappropriation Theory*

The theory of misappropriation as a means of finding liability under Rule 10b-5 had its start in the early 1980s.<sup>72</sup> The classical or traditional theory was deemed by a number of circuits to be an insufficient basis upon which the Courts could effect the purposes of the SEC in its formulation of Rule 10b-5.<sup>73</sup> *Chiarella* limited the scope of people who could be liable for trading on material, nonpublic information to include only those who had a duty to disclose arising from "a relationship of trust or confidence."<sup>74</sup> Chief Justice Burger, however, disagreed with the majority in this case and stated that, according to his interpretation of section 10(b) and Rule 10b-5, any person "who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."<sup>75</sup> The Chief Justice discussed his opinion that liability should be found where any person is engaged in a fraudulent scheme in connection with the purchase or sale of securities, and that the scope of those who could be found liable should not be limited to merely "corporate insiders" or to those who inappropriately

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69. See *id.* at 660.

70. See *Chiarella*, 445 U.S. at 232.

71. See *Dirks*, 463 U.S. at 660.

72. See *United States v. Newman*, 664 F.2d 12, 15-19 (2d Cir. 1981)

73. See *infra* note 79.

74. *Chiarella v. United States*, 445 U.S. 222, 230 (1980).

75. *Id.* at 240 (Burger, C.J., dissenting).

traded on "corporate information."<sup>76</sup> Burger posited that section 10(b) and Rule 10b-5 were meant to aid in the maximization of equality and fairness and minimization of disparate knowledge among investors.<sup>77</sup> This dissent served as the catalyst for the development of the misappropriation theory.

The *Dirks* Court, in addition to imposing a duty to disclose or abstain on tippees, also appeared to support the misappropriation theory. The Court's endorsement of the misappropriation theory is evidenced in a footnote in the decision stating the following:

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic, corporate information, but rather that they have entered into a special, confidential relationship in the conduct of business of the enterprise and are given access to information solely for corporate purposes.<sup>78</sup>

Many courts have taken into account Chief Justice Burger's dissenting opinion in *Chiarella*, as well as the implied endorsement of the misappropriation theory in *Dirks*, to broaden the narrow application of section 10(b) and Rule 10b-5 and apply the misappropriation theory in varied forms. These courts have utilized the misappropriation theory as a tool by which to promote fairness and equitability in the securities industry.<sup>79</sup>

Under the misappropriation theory, criminal liability can be imposed upon an individual who (1) misappropriates confidential information (2) in breach of any duty arising out of a relationship of trust and confidence and (3) uses the confidential information in a securities transaction.<sup>80</sup> The misappropriation theory extends the reach of Rule 10b-5 to outsiders who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade.<sup>81</sup> Accordingly, liability would be extended to anyone who breaches a fiduciary duty to any lawful possessor of material nonpublic information.<sup>82</sup> To understand the impact of the *O'Hagan* decision, it is important to analyze the development of the misappropriation theory through the circuits.

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76. *Id.* (Burger, C.J., dissenting).

77. *See id.* at 241 (Burger, C.J., dissenting).

78. *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

79. The first circuit which essentially adopted the misappropriation theory was the Second Circuit. *See United States v. Newman*, 664 F.2d 12, 15-19 (2d Cir. 1981). The Ninth and Seventh Circuits later applied a misappropriation theory similar to that initially applied in the Second Circuit. *See SEC v. Maio*, 51 F.3d 623, 633-35 (7th Cir. 1995); *SEC v. Cherif*, 933 F.2d 403, 408 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 444-48 (9th Cir. 1990).

80. The theory behind liability for misappropriation is laid out in Chief Justice Burger's dissenting opinion in *Chiarella*. *See Chiarella v. United States*, 445 U.S. 222, 239-45 (1980) (Burger, C.J., dissenting). *See supra* notes 74-77 and accompanying text.

81. *See SEC v. Cherif*, 993 F.2d 403, 409 (7th Cir. 1991).

82. *See id.*

### A. The Second Circuit

In 1981, the Second Circuit in *United States v. Newman*<sup>83</sup> was the first circuit to adopt the misappropriation theory.<sup>84</sup> In *Newman*, two employees of a New York brokerage firm misappropriated confidential information entrusted to their employers regarding certain mergers and acquisitions, and subsequently conveyed this information to Newman.<sup>85</sup> Newman, as well as three other individuals with whom he shared this information, purchased stock in the target company. All who traded on this information made large sums of money after public announcement of the mergers.<sup>86</sup>

The *Newman* Court decided that, even though Newman committed no fraud against the person from whom he was buying stock, his conduct constituted a criminal violation of section 10(b) and Rule 10b-5.<sup>87</sup> Such liability was found in spite of the fact that neither the New York brokerage firm nor its client was a purchaser or seller of the target company's securities.<sup>88</sup> Newman was convicted irrespective of the fact that he did not commit fraud on a purchaser or seller of securities.

Two years later, the Second Circuit rejected the misappropriation theory in *Moss v. Morgan Stanley*,<sup>89</sup> a case involving a private right of action with the same facts as *Newman*.<sup>90</sup> The *Moss* court, interpreting the *Chiarella* and *Dirks* Courts' comments on the issue of misappropriation, found that section 10(b) and Rule 10b-5 are meant to protect investors against fraud but are not intended to remedy all situations where there is undesirable conduct involving securities.<sup>91</sup> The court found that the defendants did not have a duty to disclose or abstain with respect to *Moss* and committed no fraud in purchasing shares of stock.<sup>92</sup> The court held that *Moss*' suit based on the misappropriation theory contradicted Supreme Court precedent and failed to state a valid section 10(b) or Rule 10b-5 cause of action.<sup>93</sup>

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83. 664 F.2d 12 (2d Cir. 1981).

84. *See id.* at 15-19.

85. *See id.* at 15. Newman was a securities trader and manager of the over-the-counter trading department of a New York brokerage firm. *See id.*

86. *See id.*

87. *See id.* at 16.

88. *See id.* These holdings are consistent with the language expressed in Rule 10b-5, which does not contain any explicit requirements that fraud be perpetrated on either the seller or buyer of securities. *See id.* at 17.

89. 719 F.2d 5 (2d Cir. 1983). *Moss* was a shareholder of Morgan Stanley who sold his shares in one of the target companies in which Newman had purchased stock based upon information supplied by insiders of Morgan Stanley. *See id.* at 8. *Moss* sought to recover damages from Newman for his violation of section 10(b) and Rule 10b-5, as well as from Morgan Stanley under the theory of derivative liability stemming from the wrongdoing of one of the defendants who misappropriated the information. *See id.* at 8-9.

90. *See id.* at 16.

91. *See id.*

92. *See id.*

93. *See id.*

In 1984, one year after the *Moss* decision, the Second Circuit upheld the misappropriation theory in *SEC v. Materia*.<sup>94</sup> *Materia* was employed by Bowne Inc., a financial printer, as a "copyholder" to proofread drafts of financial documents.<sup>95</sup> Despite the fact that the names of four tender offer targets had been omitted from the documents, and despite Bowne's efforts to maintain complete confidentiality for its clients, *Materia* was able to identify the four companies.<sup>96</sup> *Materia* subsequently purchased stock in the target companies prior to the tender offers being publicly announced, resulting in significant gains for *Materia*.<sup>97</sup>

Although *Materia* did not contest the finding that he misappropriated and traded on confidential information for his own betterment, he did argue that trading on information uncovered while on the job did not constitute a finding of fraud under section 10(b) or Rule 10b-5.<sup>98</sup> The court, however, found that *Materia*'s act of misappropriating material, nonpublic information fell under the requirements of "fraud or deceit" found in the language of Rule 10b-5.<sup>99</sup> The court reasoned that *Materia* acted fraudulently when he stole the information and likened this act to converting the corporation's funds for personal gain.<sup>100</sup> *Materia* also argued that he could not have defrauded his employer due to his lack of knowledge of the confidentiality of his work.<sup>101</sup> The court held that Bowne made sufficient attempts to express the need for confidentiality with respect to a client's confidential information.<sup>102</sup> The court also found that, despite the fact that *Materia* could not be considered a traditional insider with historically no duty to disclose or abstain, he was still in violation of the misappropriation theory.<sup>103</sup> The *Materia* court held that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates section 10(b) and Rule 10b-5."<sup>104</sup>

Not long after *Materia*, a district court within the Second Circuit decided *SEC v. Musella*.<sup>105</sup> The *Musella* court applied a similar rationale to that applied in *Materia*, reasoning that trading on improperly obtained information, irrespective of its source, is fundamentally unfair.<sup>106</sup> In *Musella*, individuals who were not directly involved in any confidential relationship were given tips regarding a company from

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94. 745 F.2d 197, 201 (2d Cir. 1984).

95. *See id.* at 199.

96. *See id.* Bowne, Inc. had an explicit policy that was posted throughout the plant as well as disseminated to individual employees regarding the firm's prohibition of employee trades based on confidential information found in the course of any work-related activities. *See id.* at 199 n.1.

97. *See id.* at 199.

98. *See id.* at 201.

99. *See id.*

100. *See Materia*, 745 F.2d at 201-02.

101. *See id.* at 202.

102. *See id.*; *supra* note 96 and accompanying text.

103. *See Materia*, 745 F.2d at 203.

104. *Id.*

105. 678 F. Supp. 1060 (S.D.N.Y. 1988).

106. *SEC v. Musella*, 578 F. Supp. 425, 438 (S.D.N.Y. 1984).

an employee of a law firm that was representing that company in a tender offer.<sup>107</sup> The court imposed liability on the individuals who had been given information upon which they traded, even though they did not know the source from which the information originated.<sup>108</sup> The court held that a tippee who trades is liable if he knew or should have known that the information was improperly obtained.<sup>109</sup>

The Second Circuit, in *Carpenter v. United States*,<sup>110</sup> looked at the issue regarding the misappropriation theory once again. In this case, the defendants used information gleaned from the employer of one of the defendants as a basis for purchasing and selling securities.<sup>111</sup> The trial court held,<sup>112</sup> and the Second Circuit ultimately affirmed, that the misappropriation theory, when applied to the case at bar, resulted in a finding of liability stemming from a breach of confidentiality owed to the employer.<sup>113</sup> These defendants were found in violation of section 10(b) and Rule 10b-5 despite the fact that the employer did not buy or sell securities.<sup>114</sup> The Supreme Court, given the chance to address the issue of the misappropriation theory, split four to four,<sup>115</sup> giving little explanation with respect to the justification for the decision.<sup>116</sup>

The question of what constitutes a fiduciary or similar relationship of trust and confidence in the context of Rule 10b-5 under the misappropriation theory still remained open to clarification. In *United States v. Chestman*,<sup>117</sup> Loeb, a "remote tippee,"<sup>118</sup> shared with Chestman information gleaned from his wife (a member of the Waldbaum family) regarding the stock of Waldbaum, a large supermarket chain.<sup>119</sup> Although the defendant claimed that he conducted his own research on the stock, Chestman purchased shares of Waldbaum's stock for Loeb, himself, and other clients following the receipt of the information from Loeb that the Waldbaum stock was going to be sold at a "substantially higher" price than its market

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107. See *Musella*, 678 F. Supp at 1061.

108. See *id.* at 1063.

109. See *id.* (citing *Dirks v. SEC*, 463 U.S. 646, 660, 662 (1983)).

110. 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

111. See *id.* at 1026-27. This co-defendant had access to the insight of many corporate executives with regard to the current affairs of the corporations for which they worked through his co-authorship of a daily stock column published in the *Wall Street Journal*. See *id.* at 1026.

112. *United States v. Winans*, 612 F. Supp. 827, 838-39 (S.D.N.Y. 1985).

113. See *Carpenter*, 791 F.2d at 1029-31.

114. See *id.*

115. *Carpenter v. United States*, 484 U.S. 19 (1987).

116. The Court did not discuss the difference in opinions that divided the two sides, nor was there any information given regarding which justices took which side of the argument.

117. See 947 F.2d 551 (2d Cir. 1991) (en banc).

118. A "remote tippee" is an individual who obtains confidential insider information from a tippee beyond the original tip by the insider. See DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 4.04(3), at 4-20 (1997).

119. See *Chestman*, 947 F.2d at 555. Loeb's wife told Loeb with full knowledge that the information she was sharing was material, nonpublic information. See *id.*

value.<sup>120</sup> In fact, Chestman doubled his money on this trade and was ultimately convicted as a tippee of the information misappropriated by Loeb.<sup>121</sup>

The Second Circuit, however, reversed Chestman's Rule 10b-5 convictions<sup>122</sup> and stated that "a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information."<sup>123</sup> The court also stated that "the existence of a confidential relationship must be determined independently of a preexisting family relationship."<sup>124</sup> The court decided that more is required to establish a fiduciary relationship than telling a secret to a family member.<sup>125</sup> Where, however, any fiduciary relationship was found to exist, the misappropriation theory could be applied.<sup>126</sup> The government's burden of proving that Loeb breached a fiduciary duty to his wife and that Chestman had knowledge of this breach was not met.<sup>127</sup>

The Second Circuit's restriction of the misappropriation theory was tested in the case of *United States v. Willis*.<sup>128</sup> Willis, a psychiatrist, was treating the wife of Sanford Weill, a businessman involved in large transactions.<sup>129</sup> Willis, in his dealings with Mrs. Weill, learned that her husband was going to buy a bank. Willis subsequently decided to purchase shares of the bank's stock and sold them later for a substantial profit.<sup>130</sup> Although Willis initially pled guilty, he withdrew his plea, and based on the decision in *Chestman*, argued that there was no fiduciary duty imposed on Mrs. Weill and that there must be an unbroken chain of confidentiality.<sup>131</sup>

The court only looked to Willis' second argument, as it believed his first argument had no merit.<sup>132</sup> In looking to the second argument, the court found the important relationship to be between the misappropriator and the person to whom the information was misappropriated, and distinguished this from the relationship between the insider and the person with whom the insider shares the information.<sup>133</sup> The court found a fiduciary relationship existed between Willis and

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120. *Id.* at 555.

121. *See id.* at 564.

122. *See id.* at 571.

123. *Id.* at 567.

124. *Id.* at 568. A fiduciary duty can be defined as "a duty to act for someone else's benefit, while subordinating one's personal interest to that of the other person. It is the highest standard of duty implied by law (e.g., trustee, guardian)." BLACK'S LAW DICTIONARY 625 (6th ed. 1990). The court in *Chestman* noted that a "similar relationship of trust and confidence" cannot be interpreted to mean that marriage alone is equivalent to a fiduciary relationship. *Chestman*, 947 F.2d at 568.

125. *See Chestman*, 947 F.2d at 568.

126. *See id.* at 566. After *Chestman*, the misappropriation theory could be applied without the requirement that the "buyer or seller of securities be defrauded" and could be applied to "fiduciary breaches of any sort," thereby construing the "similar relationship of trust and confidence" requirement very liberally. *Id.* at 566-67.

127. *See id.* at 570.

128. 778 F. Supp. 205 (S.D.N.Y. 1991).

129. *See United States v. Willis*, 737 F. Supp. 269, 271 (S.D.N.Y. 1990). The most applicable case in this series of *Willis* cases is *Willis III*; however, the facts of the case are taken from *Willis I*.

130. *See id.*

131. *See Willis*, 778 F. Supp. at 208.

132. *See id.*

133. *See id.* In this decision, the court looked to the misappropriation theory's lack of a requirement

Mrs. Weill in connection with Willis' position as a psychiatrist.<sup>134</sup> Because the doctor-patient relationship can be deemed a fiduciary relationship, Willis had a duty to either disclose the inside information or abstain from trading in the securities of companies discussed incident to his position as a psychiatrist.<sup>135</sup>

After the *Chestman* decision, the question of whether and under what conditions the misappropriation theory can be applied in the context of a tipper-tippee fact pattern remained unclear.<sup>136</sup> This issue was addressed by the Supreme Court in *United States v. Libera*.<sup>137</sup> In *Libera*, the defendant, a printer for Business Week, utilized his access to copies of the magazine prior to publication to obtain information upon which he traded.<sup>138</sup> Libera was aware of his employer's strict rules with respect to the confidentiality of any information that had not yet been published.<sup>139</sup>

In *Libera*, the Second Circuit rejected the argument that a tipper has to have knowledge that misappropriating the information in breach of a fiduciary duty will lead to trading on that information thereby amounting to a violation of section 10(b).<sup>140</sup> The court determined that such a requirement would only serve as a loophole for misappropriating information.<sup>141</sup> The court left unchanged the elements of the misappropriation theory as espoused in *Chestman*, namely "(i) a breach by the tipper of a duty owed to the owner of the nonpublic information; and (ii) the tippee's knowledge that the tipper had breached the duty."<sup>142</sup>

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that the breach of duty be related directly to the corporation or its shareholders. *See id.*

134. *See id.* at 209.

135. *See id.* at 209.

136. In *Chestman*, the misappropriation theory was not applied because the tipper was found not to have breached a duty to the source of the information. *See United States v. Chestman*, 947 F.2d 551, 571 (2d Cir. 1991) (en banc). The *Chestman* court opted to "tread cautiously in extending the misappropriation theory to new relationships" in an effort to minimize the chance of allowing Rule 10b-5 to become too all-encompassing. *Id.* at 567; *see also supra* notes 117-26 and accompanying text (discussing *Chestman*).

137. 989 F.2d 596 (2d Cir. 1993).

138. *See id.* at 598-99.

139. *See id.* Libera's awareness of the policy of keeping the information contained within the magazine confidential prior to its Thursday, 5 p.m. release can be assumed based on the distribution of a memorandum, as well as R.R. Donnell & Sons' company-wide policies. *See id.*

140. *See id.* at 600. The Court expressed its concern in allowing a tippee to escape liability simply because it was too difficult to prove to a jury that the tipper had knowledge of the exact misuse that would result from his misappropriation and tip. *See id.*

141. *See id.*

142. *Id.* (citing *United States v. Chestman*, 947 F.2d 551, 570 (2d Cir. 1991) (en banc)). The court reasoned that the tipper's knowledge that he was breaching a duty to the owner of confidential information was sufficient to establish an expectation that the breach would lead to some kind of misuse of the information. *See Libera*, 989 F.2d at 600. The court explained that the purposes of the misappropriation theory in protecting property rights would not be met if the government were forced to prove that a tipper had specific knowledge of the consequences of his or her breach. *See id.*



### B. The Third Circuit

In 1985, the Third Circuit chose to adopt the misappropriation theory in *Rothberg v. Rosenbloom*.<sup>143</sup> In this case, Rosenbloom obtained information from an insider of a target corporation regarding sales figures, which far surpassed the prior year's figures.<sup>144</sup> This information was subsequently communicated to Rothberg, with whom the Rosenblooms joined to invest in the target company prior to public disclosure of the outstanding sales figures.<sup>145</sup> The Third Circuit noted the defendants' positions within the acquiring company and the breach of duty in disclosing the insider information to their company. Citing *United States v. Newman*<sup>146</sup> as the basis for its holding,<sup>147</sup> the court made the outside misappropriator an "insider" by virtue of his relationship to a corporation that was seeking to acquire the company whose shares were traded.<sup>148</sup> Because the Third Circuit imposed a duty was imposed beyond that owed to the purchasers and sellers of securities, its application of the misappropriation theory has been viewed as a stretch. In fact, the court in *Rothberg* merely referred to the theory in a single sentence of its holding, but did not term it the "misappropriation theory."<sup>149</sup>

### C. The Fourth Circuit

The misappropriation theory was first rejected by the Fourth Circuit in *United States v. Bryan*,<sup>150</sup> thereby limiting the theory's expansion into that circuit. In *Bryan*, the defendant was the director of a state lottery who had access to confidential, non-public information regarding a company that was going to be awarded a lucrative government contract.<sup>151</sup> Bryan subsequently used the misappropriated confidential information to purchase shares of that company.<sup>152</sup>

The Fourth Circuit invalidated the theory of misappropriation adopted by a number of the circuits.<sup>153</sup> The *Bryan* court found it necessary to look beyond past applications of the misappropriation theory in its determination of whether criminal liability under section 10(b) and Rule 10b-5 could be found.<sup>154</sup> Following Supreme Court precedent, the *Bryan* court held that the fraud element of Rule 10b-5 has to

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143. 771 F.2d 818, 822-23 (3d Cir. 1985).

144. *See id.* at 820.

145. *See id.*

146. 664 F.2d 12 (2d Cir. 1981).

147. *See Rothberg*, 771 F.2d at 822-23; *see also supra* notes 83-88 and accompanying text (discussing *Newman*).

148. *See* Wade M. Hall, *Insider Trading Liability: Are We Ready to Leave the Misappropriation Theory Quagmire?*, 44 U. KAN. L. REV. 867, 878 (1996).

149. *See Rothberg*, 771 F.2d at 822; *United States v. Bryan*, 58 F.3d 933, 944 n.5 (4th Cir. 1995).

150. 58 F.3d 933 (4th Cir. 1995).

151. *See id.* at 937.

152. *See id.*

153. *See id.* at 944-49. The Court found that section 10(b), Rule 10b-5, and the interpretation of these provisions by the Supreme Court do not sufficiently support a conviction under the misappropriation theory where there was no duty owed to the buyer or seller of securities. *See id.* at 944.

154. *See id.*

be satisfied by a breach of a duty to disclose owed to the buyer or seller of securities, which was greater than the standard requiring the fraud be "in connection with the purchase or sale of any security."<sup>155</sup> The Fourth Circuit concluded that its decision must be consistent with the Supreme Court's holdings in both *Chiarella* and *Dirks*; otherwise, the ultimate result would be a "patchwork of criminal standards" and a "federalization of relationships historically regulated by the states."<sup>156</sup> The court believed that the adoption of the misappropriation theory added further uncertainty to the laws governing fraudulent securities transactions<sup>157</sup> and held that misappropriating information from an individual who is in no way connected to securities cannot be construed as conduct the SEC intended to eliminate with the formation of these rules.<sup>158</sup> The *Bryan* court's findings demonstrate a rejection of the misappropriation theory. The court stated, however, that unlawful transactions will be more appropriately policed by the classical theory as espoused in the *Chiarella* and *Dirks* holdings.<sup>159</sup>

The Fourth Circuit applied the so-called "Bryan test"<sup>160</sup> in *United States v. ReBrook*.<sup>161</sup> The *ReBrook* case was based on the same facts as those in *Bryan*. ReBrook worked with Bryan as an attorney for the same state lottery.<sup>162</sup> Bryan gave ReBrook the information he had, and ReBrook subsequently purchased shares in the company that was going to be awarded a government contract without disclosing to the Lottery Commission the intent to make use of the information.<sup>163</sup> ReBrook was initially convicted by the trial court of securities fraud.<sup>164</sup> This was later reversed when the court of appeals applied what it termed "straightforward reasoning" in *Bryan*.<sup>165</sup> The Fourth Circuit made it clear that they rejected the misappropriation theory as envisioned by the other circuits entirely, not just as applied to the particular facts in *Bryan*.<sup>166</sup> Finding that ReBrook "simply took advantage of the information to which he was privy," which was a similar action

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155. *Id.* at 959. The Court also looked to *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), to support its findings that section 10(b) is primarily concerned with purchasers and sellers of securities. *See Bryan*, 58 F.3d at 947.

156. *Id.* at 951. The Court found that the misappropriation theory is excessively broad in its allowance of the imposition of liability upon "the mere breach of a fiduciary relationship or similar relationship of trust and confidence." *Id.* at 949.

157. *See id.* at 952-53.

158. *See id.* at 949.

159. *See id.* at 953.

160. The "Bryan test" evaluates whether deception was used "in the form of material misrepresentations or omissions, to induce action or inaction by purchasers or sellers of securities, or that affects others with a vested interest in a securities transaction." *United States v. ReBrook*, 58 F.3d 961, 966 (4th Cir.) (citing *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995)).

161. 58 F.3d 961 (4th Cir. 1995); *see also supra* notes 150-59 and accompanying text (discussing *Bryan*).

162. *See ReBrook*, 58 F.3d at 963.

163. *See id.* at 964.

164. *See United States v. ReBrook*, 842 F. Supp. 891 (S.D. W. Va. 1994).

165. *See ReBrook*, 58 F.3d at 966.

166. *See id.*

taken by Bryan, the Fourth Circuit concluded that ReBrook's conviction for securities fraud violations should be reversed.<sup>167</sup>

#### *D. The Seventh Circuit*

The Seventh Circuit grappled with and adopted the misappropriation theory in *SEC v. Cherif*.<sup>168</sup> Cherif, the defendant, was a former employee of a national bank who gained access to inside information concerning tender offers and leveraged buyouts with respect to the bank. Knowing of the bank's integrity policy, Cherif fraudulently reactivated his employee magnetic identification card to obtain information from the bank's finance department, and ultimately traded on the information to which he gained access.<sup>169</sup> Cherif hid the money in accounts, which were opened in other people's names.<sup>170</sup>

The Seventh Circuit relied on the analysis from the Second Circuit holdings in *Newman*, *Materia*, and *Carpenter* and "join[ed] these courts in holding that a person violates Rule 10b-5 and section 10(b) of the Securities Exchange Act of 1934 by misappropriating and trading upon material information entrusted to him by virtue of a fiduciary relationship such as employment."<sup>171</sup> Cherif, however, argued that he owed no fiduciary duty to the bank, as he was no longer an employee.<sup>172</sup> The court explained, however, that this relationship must continue to exist even following termination.<sup>173</sup> Cherif's trades following his obtainment of the material, nonpublic information related to potential deals were "in connection with" the entire fraudulent scheme.<sup>174</sup> Accordingly, the Seventh Circuit affirmed the trial court's finding that Cherif violated section 10(b) and Rule 10b-5, noting that "[t]he misappropriation theory focuses not on the insider's fiduciary duty to the issuing company or its shareholders but on whether the insider breached a fiduciary duty to any lawful possessor of nonpublic information."<sup>175</sup>

The Seventh Circuit further expanded its application of the misappropriation theory in *SEC v. Maio*.<sup>176</sup> In this case, Ferrero, the president, CEO, and chairman of a large company told his friend, Maio, who in turn told a second friend, Ladavac, that this company was in the process of negotiating a tender offer for stock in

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167. *Id.*

168. 933 F.2d 403 (7th Cir. 1991).

169. *See id.* at 406. The bank's Specialized Finance Department provided financing for business transactions including tender offers and leveraged buy-outs. *See id.*

170. *See id.* at 406-07.

171. *Id.* at 410.

172. *See id.* at 411.

173. *See id.* A broad common law duty obligates an employee, past or present, to protect confidential information entrusted to the employee throughout the course of employment. *See id.*

174. *Id.*

175. *Id.* at 406. The court found that the breach of duty with respect to Cherif was not in the acquisition of the information, but rather, was in the improper use of the access card, as well as the bank's inside information, which were entrusted to Cherif through his fiduciary relationship prior to his termination. *See id.* at 411.

176. 51 F.3d 623 (7th Cir. 1995).

another corporation.<sup>177</sup> The tippees, Maio and Ladavac, then traded in the corporation's stock, as well as the target's stock on the basis of this material, nonpublic information.<sup>178</sup> Strong evidence existed with respect to Maio and Ladavac's knowledge that Ferraro had violated his fiduciary duty to the corporation by disclosing to the "tippees" that the corporation would be making a tender offer.<sup>179</sup> Accordingly, the court imposed a derivative duty not to trade because, although Ferraro breached his fiduciary duty to his company, Maio and Ladavac knew this disclosure to be improper.<sup>180</sup>

In this case, the court applied the test established in *Dirks*<sup>181</sup> to extend the misappropriation theory to the tippees of the misappropriator.<sup>182</sup> The court affirmed the holding in *Dirks* that a tippee has a "derivative duty not to trade on material, nonpublic information when the disclosure of information is improper and the tippee knows or should know that this is the case."<sup>183</sup> Thus, the SEC could extend insider trading liability to those who did not owe a fiduciary duty, but rather had a "derivative duty" to the corporations involved in a tender offer where the tippee "knew or should have known that the disclosure was improper."<sup>184</sup>

#### E. The Ninth Circuit

In 1990, six years after the decision in *Materia*, the Ninth Circuit, in *SEC v. Clark*<sup>185</sup> held that the misappropriation theory extends to trading by outsiders.<sup>186</sup> In this case, Clark traded secretly on information that he knew was confidential.<sup>187</sup> The Ninth Circuit examined whether Congress had granted the SEC the power to create rules which encompass the misappropriation theory.<sup>188</sup> Citing the Securities Exchange Act of 1934,<sup>189</sup> the Insider Trading Sanctions Act of 1984,<sup>190</sup> and the

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177. *See id.* at 626-27.

178. *See id.*

179. *See id.* at 629.

180. *See id.* Maio and Ladavac, upon buying and selling shares in this company, as well as the target company, without disclosing the material, nonpublic information in their possession, breached their derivative duty to the company from which the information was derived. *See id.* at 637-38.

181. *See Dirks v. SEC*, 463 U.S. 646, 660 (1983); *supra* notes 64-68 and accompanying text.

182. *See Maio*, 51 F.3d at 632. The court found that Maio had a derivative duty not to trade in the company's stock on the basis of the material, nonpublic information provided by Ferrero if he knew or should have known that Ferrero had provided this information in violation of his fiduciary duty his company. *See id.* at 633; *see also Dirks*, 463 U.S. at 661 (citing *In re Investors Mgmt. Co.*, 44 S.E.C. 633, 651 (1971)) ("[T]ippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information . . .").

183. *Maio*, 51 F.3d at 632 (citing *Dirks*, 463 U.S. at 659-60).

184. *Id.* at 634.

185. 915 F.2d 439 (9th Cir. 1990).

186. *See id.* at 443. In *Clark*, a co-officer of a company knowingly leaked confidential, nonpublic information to Clark regarding a potential takeover. *See id.* at 441-42. Clark, in turn, purchased the target company's stock and attempted to hide his purchases by making trades in the maiden name of his wife. *See id.*

187. *See id.*

188. *See id.* at 443.

189. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (1994 & Supp. I 1995).

Insider Trading and Securities Fraud Enforcement Act of 1988,<sup>191</sup> the court found that section 10(b) was meant to be broad.<sup>192</sup> The Court found strong evidence that the misappropriation theory falls within the meaning of fraud found in section 10(b) and Rule 10b-5.<sup>193</sup> Clark was found liable under Rule 10b-5, and was ultimately forced to disgorge his profits as well as pay a fine.<sup>194</sup>

#### IV. O'Hagan: Facts and Proceedings

##### A. The Facts

In July 1988, Grand Met PLC (Grand Met), a company based in London, England, retained Dorsey & Whitney, a law firm based in Minneapolis, Minnesota, to represent them as local counsel in preparation for the potential acquisition of the Minneapolis-based Pillsbury Company (Pillsbury).<sup>195</sup> Prior to the announcement of Grand Met's tender offer, James Herman O'Hagan, a Dorsey & Whitney partner who was not personally involved in representing Grand Met, began to purchase Pillsbury securities.<sup>196</sup> By the time Grand Met publicly announced its tender offer for Pillsbury in September, O'Hagan had purchased 2,500 call options and 5,000 shares of Pillsbury common stock.<sup>197</sup> After the tender offer, the price of Pillsbury stock rose to just under \$60 per share, at which time O'Hagan sold both his call options and his shares of common stock for a profit of more than \$4.3 million.<sup>198</sup>

##### B. The Case in the Lower Court

The Securities and Exchange Commission (SEC) investigation of O'Hagan ended in a fifty-seven-count indictment which included counts for securities fraud, mail fraud, and money laundering.<sup>199</sup> The securities fraud case against O'Hagan was based on the misappropriation theory of liability for insider trading.<sup>200</sup> The "classical theory" of insider trading was unavailable to the SEC because O'Hagan traded in Pillsbury securities, a company to which neither he nor his law firm owed

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190. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

191. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.).

192. *See Clark*, 915 F.2d at 450. The court stated that the SEC's adoption of Rule 10b-5 was intended to reach fraudulent acts beyond those committed on the purchaser or seller of securities. *See id.* These rules were meant to protect public interest, and as such, could be interpreted broadly. *See id.*

193. *See id.* at 453.

194. *See id.* at 442.

195. *See United States v. O'Hagan*, 117 S. Ct. 2199, 2205 (1997).

196. *See id.*

197. *See id.*

198. *See id.* Pillsbury stock rose from \$39 a share to nearly \$60 a share when the tender offer was publicly announced. *See id.*

199. *See id.*

200. *See id.* at 2206.

a fiduciary duty.<sup>201</sup> Following a jury trial, O'Hagan was convicted on all fifty-seven counts and sentenced to forty-one months of imprisonment.<sup>202</sup>

O'Hagan appealed his conviction to the Court of Appeals for the Eighth Circuit, arguing that the misappropriation theory was an impermissible basis on which to impose liability under section 10(b).<sup>203</sup> The Eighth Circuit, following the Fourth Circuit's lead in *United States v. Bryan*,<sup>204</sup> agreed with O'Hagan and rejected the misappropriation theory as a basis for section 10(b) liability.<sup>205</sup> The court noted that, because O'Hagan's convictions for mail fraud and money laundering were based on the securities law violations, they were forced to reverse and remand the case to the district court for dismissal of the entire indictment.<sup>206</sup>

The Eighth Circuit based its decision on two primary grounds. First, in looking at section 10(b) itself, the court found that the language of the statute shows no intention of Congress to prohibit any conduct other than manipulation or deception.<sup>207</sup> The court concluded that because the misappropriation theory requires neither misrepresentation nor nondisclosure, it fails to require "deception" as delineated in section 10(b).<sup>208</sup> The court found that this failure to require deception made the misappropriation theory an invalid means of determining section 10(b) liability.<sup>209</sup> The court followed and relied upon the holdings in both *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*<sup>210</sup> and *Santa Fe Industries,*

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201. *See id.* at 2208 n.5. The Court stated:

The Government could not have prosecuted O'Hagan under the classical theory, for O'Hagan was not an "insider" of Pillsbury, the corporation in whose stock he traded. Although an "outsider" with respect to Pillsbury, O'Hagan had an intimate association with, and was found to have traded on confidential information from, Dorsey and Whitney, counsel to tender offeror Grand Met.

*Id.*

202. *See United States v. O'Hagan*, 92 F.3d 612, 614 (1996), *rev'd*, 117 S. Ct. 2219 (1997).

203. *See id.*

204. 58 F.3d 933 (4th Cir. 1995) (finding that there is no fiduciary duty owed to one who is neither a purchaser nor seller of securities, even when such a breach is followed by the purchase or sale of securities). The *Bryan* Court went on to say that such conduct "simply does not constitute fraud in connection with the purchase or sale of securities, within the meaning of section 10(b)." *See id.* at 952; *see also Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 n.5 (1975) ("[T]he wording of § 10(b), making fraud in connection with the purchase or sale of a security a violation of the Act, is surely badly strained when construed to provide a cause of action, not to purchasers and sellers of securities, but to the world at large.").

205. *See O'Hagan*, 92 F.3d at 614. The court emphasized that section 10(b) is meant to police the fairness of securities transactions in general, as long as there is no evidence of deception in connection with a securities transaction (in the form of material misrepresentations or omissions in connection with the transaction). *See id.* at 615.

206. *See O'Hagan*, 92 F.3d at 627-28.

207. *See id.* at 616; *see also Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception. Nor have we been cited to any evidence in the legislative history that would support a departure from the language of the statute.").

208. *See O'Hagan*, 92 F.3d at 618 ("The misappropriation theory runs counter to *Santa Fe* and *Central Bank* holdings that the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of § 10(b).").

209. *See O'Hagan*, 92 F.3d at 617.

210. 114 S. Ct. 1439 (1994). In *Central Bank*, the Court confirmed that neither misrepresentation

*Inc. v. Green*<sup>211</sup> in its rejection of the lower court's holdings and conclusion that the misappropriation theory does not require "deception."<sup>212</sup>

Second, the court concluded that the misappropriation theory fails to meet section 10(b)'s requirement that the "deception" be "in connection with the purchase or sale of any security."<sup>213</sup> The court found that the misappropriation theory "permits liability for a breach of a duty owed to individuals who are unconnected to and perhaps uninterested in a securities transaction, thus rendering meaningless the 'in connection with . . . ' statutory language."<sup>214</sup> The court, in agreement with the *Bryan* court, held that the Supreme Court intended section 10(b) to only protect "purchasers and sellers of securities."<sup>215</sup> The court found the misappropriation theory to be more of an expansive "general fraud-on-the-source theory," as opposed to its intended purpose of governing and protecting relations among participants within the market.<sup>216</sup>

### C. The Supreme Court Opinion

The Supreme Court, in a majority opinion written by Justice Ruth Bader Ginsburg, disagreed with the Eighth Circuit and held that "criminal liability under section 10(b) may be predicated on the misappropriation theory."<sup>217</sup> The Court found that the misappropriation theory was both consistent with section 10(b) and with the Court's precedent.<sup>218</sup> The Court found that the misappropriation theory "is also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence."<sup>219</sup> The *O'Hagan* Court, in its decision, opened up liability under section 10(b) and Rule 10b-5 for any person who trades in securities for personal profit using material, nonpublic information that was misappropriated in breach of a fiduciary duty to the source of the information.<sup>220</sup>

The Court began its analysis by examining whether the misappropriation theory satisfies section 10(b)'s requirement that the chargeable conduct involve a "deceptive device or contrivance" used in "connection with" the purchase or sale

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or nondisclosure are requirements for liability under section 10(b). *See id.* at 1448.

211. 430 U.S. 462 (1977). In *Sante Fe Industries*, the Court explicitly rejected the lower court's interpretation of section 10(b) which required no misrepresentation or nondisclosure. *See id.* at 470-76.

212. *O'Hagan*, 92 F.3d at 617-18.

213. *Id.* at 618.

214. *Id.* The Eighth Circuit states that a "careful reading of the Supreme Court's decisions in *Chiarella*, *Dirks*, and *Central Bank* reveals that only a breach of a duty to parties to the securities transaction or, at the most, to other market participants such as investors, will be sufficient to give rise to § 10(b) liability." *Id.*

215. *Id.* (citing *United States v. Bryan*, 58 F.3d 933, 946-47 (4th Cir. 1995) ("The [Supreme] Court has left no doubt that the principal concern of section 10(b) is the protection of purchasers and sellers of securities.")).

216. *Id.* at 619.

217. *United States v. O'Hagan*, 117 S. Ct. 2199, 2206 (1997).

218. *See id.* at 2213-14.

219. *Id.* at 2210.

220. *See id.* at 2206-14.

of securities.<sup>221</sup> The Court stated that misappropriators "deal in deception."<sup>222</sup> Quoting from the Government's brief, the Court stated: "A fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain 'duplicates' or defrauds the principal."<sup>223</sup> Thus, when O'Hagan failed to disclose that he was interested in trading on the tender offer information, he was deceptive and breached a duty of trust to both Dorsey & Whitney and Grand Met. The Court then went on to find that disclosure could eliminate the issue of deception.<sup>224</sup> "Full disclosure forecloses liability under the misappropriation theory," the Court explained.<sup>225</sup> The misappropriation theory involves deception whereby one "duplicates or defrauds"<sup>226</sup> the source of the information. Thus, "if the fiduciary discloses to the source that he plans to trade on nonpublic information, there is no deceptive device and thus no section 10b violation."<sup>227</sup>

Next, the Court looked at whether the misappropriation theory satisfies the section 10(b) requirement that the misappropriator's "deceptive use of information be 'in connection with the purchase or sale of [a] security.'"<sup>228</sup> The Court concluded that this element is satisfied when the misappropriator "uses the information to purchase or sell securities" without telling his principals.<sup>229</sup> The Court makes clear that the misappropriation theory deals not only with the unfairness or lack of disclosure to the marketplace as a whole, but also with the injury that the source of the information suffers.<sup>230</sup> However, the Court pointed out that, although the misappropriation theory catches fraudulent means of capitalizing on such information through securities transactions, it does not catch all conceivable forms of fraud involving confidential information.<sup>231</sup> Essentially, the misappropriation theory is meant to be a means of attaching liability in the event that a person learns inside information and secretly uses it to "gain no-risk profits."<sup>232</sup>

The Court stressed that persons can be prosecuted only for "willfully" violating Rule 10b-5.<sup>233</sup> This stricter scienter requirement could serve to limit criminal liability under the misappropriation theory.<sup>234</sup> Prosecutors must prove that the

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221. *See id.* at 2208.

222. *Id.*

223. *Id.* at 2208 (citing Brief for United States at 17, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997) (No. 96-842)); *see also* Aldave, *supra* note 29, at 119 (discussing how a misappropriator is guilty of deceiving the party who put trust and confidence in him when that person conveys it to others or trades on the basis of it).

224. *See O'Hagan*, 117 S. Ct. at 2208.

225. *Id.*

226. *Id.* at 2209 (citing Brief for United States at 17).

227. *Id.* at 2209.

228. *Id.*

229. *Id.*

230. *See id.*

231. *See id.*

232. *Id.*

233. *Id.* at 2214.

234. *See id.*



misappropriator "willfully" violated the rule, and the defendants cannot be imprisoned if there is proof that there was no knowledge of the rule.<sup>235</sup> This safeguard is meant to ensure that an innocent and naïve person will not be wrongly sent to prison for an honest mistake.

The Court also attempted to reconcile its decision in *O'Hagan* with its rationale in the *Chiarella*, *Dirks*, and *Central Bank* holdings. In each of these cases, the Court found that section 10(b) liability could not be found where a duty was not owed to the source of nonpublic information.<sup>236</sup> In *Chiarella*, the Court found a duty to disclose or abstain from trading "arises from a specific relationship between two parties,"<sup>237</sup> and for this reason held that liability could not be imposed on the defendant who had no agency or other fiduciary relationship with the sellers.<sup>238</sup> The Court in *O'Hagan* points out, however, that the *Chiarella* decision did not imply that the only relationship which could amount to liability under the misappropriation theory was one between corporate insiders and shareholders.<sup>239</sup>

The *O'Hagan* Court then looked at the application of the misappropriation theory in *Dirks*. In *Dirks*, the Court refused to apply the SEC's view that there was a duty to refrain from communicating nonpublic information to anyone likely to trade based on that information.<sup>240</sup> The Court in *Dirks* found that no general duty existed between all participants in all market transactions to suspend or forgo action based on information that was both material and nonpublic.<sup>241</sup> The Court noted that the tippees in *Dirks* were not acting for personal profit, but rather to expose fraud. Therefore, *Dirks* could not misappropriate the information because there was no expectation that he would keep it in confidence.<sup>242</sup> The distinction in *Dirks* was that there was no violation by the tippees, and thus no derivative liability could be attributed to the tippee.<sup>243</sup>

Finally, the Court looked to *Central Bank's* holding that a private plaintiff may not bring an aiding and abetting suit under section 10(b).<sup>244</sup> The Court clarified this holding by adding that, even though secondary actors, such as a lawyer, accountant, or bank, are not subject to liability for aiding and abetting,<sup>245</sup> these actors may be subject to "primary liability under section 10(b) and Rule 10b-5 for

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235. *See id.* The Court explains: "To establish a criminal violation of Rule 10b-5, the Government must prove that a person 'willfully' violated the provision. Furthermore, a defendant may not be imprisoned for violating Rule 10b-5 if he proves that he had no knowledge of the rule." *Id.* (citing 15 U.S.C. § 78ff(a) (1994)).

236. *See id.* at 2211.

237. *Chiarella v. United States*, 445 U.S. 222, 223 (1980), *quoted in O'Hagan*, 117 S. Ct. at 2212.

238. *See O'Hagan*, 117 S. Ct. at 2211.

239. *See id.* at 2212.

240. *See Dirks v. SEC*, 463 U.S. 646, 655-59 (1983).

241. *See id.* at 655 (quoting *Chiarella*, 445 U.S. at 233).

242. *See O'Hagan*, 117 S. Ct. at 2213.

243. *See id.* at 2213 (citing *Dirks*, 463 U.S. at 655).

244. *See id.* (citing *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 551 U.S. 164, 191 (1994)).

245. *See id.*

certain conduct.<sup>246</sup> Despite the fact that the aforementioned cases showed a willingness to limit the scope of the application of the misappropriation theory, the cases did not undermine the validity of the theory itself.

The Court, in the *O'Hagan* opinion, appears to be open to the assessment of liability based upon the misappropriation theory for anyone, however remote from the insider, who trades on information gleaned from a source to which some duty is owed. The Court's definition of duty applies to any parties with a specific relationship. The specific relationship is established by the act of exchanging the material, nonpublic information prior to public dissemination of this information. This relationship is broad and left open to anyone who is regularly entrusted with the confidential information.<sup>247</sup> There is no list or specific guideline specified by the Court to determine what particular relationships give rise to a duty to disclose or abstain. The Court appears to be leaving this definition broad so as not to limit liability for individuals who misappropriated information and did not have a traditional, definable fiduciary relationship.

In dissent,<sup>248</sup> Justice Clarence Thomas, joined by Chief Justice William H. Rehnquist, stated that the misappropriation theory could not be upheld in this case and could not be a basis upon which *O'Hagan* could be convicted.<sup>249</sup> Thomas explained that his dissent is a result of the SEC's failure to provide a concise and consistent interpretation of section 10(b)'s requirement that a deceptive device be "use[d] or employ[ed], in connection with" the purchase or sale of any security.<sup>250</sup> Thomas found the Commission's interpretation of section 10(b) and Rule 10b-5 to be inconsistent and lacking any predictable guidance as to what behavior amounts to liability under the statute.<sup>251</sup>

### *V. The Impact of O'Hagan and the Search for an Appropriate Standard*

#### *A. Relationships and Remote Tippees Under O'Hagan*

The Court in *O'Hagan* adopted an open-ended test of Rule 10b-5 liability. The decision permits a finding of liability for any individual who has some "duty of confidentiality" to the source.<sup>252</sup> While there is no question that accountants, lawyers, and investment bankers in a position of trust who learn about a pending takeover should not abuse their position, individuals outside a traditional fiduciary

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246. *Id.*

247. *See id.* at 2207.

248. Justice Scalia concurred in part and dissented in part with a separate opinion. Scalia discussed, among other things, the application of the principle of lenity to criminal statutes. Scalia stated that "in light of [the lenity principle], it seems to me that the unelaborated statutory language: '[t]o use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance,' § 10(b) must be construed to require the manipulation or deception of a party to a securities transaction." *Id.* at 2220 (Scalia, J., concurring in part and dissenting in part).

249. *See id.* at 2224 (Thomas, J., dissenting).

250. *See id.* at 2222 (Thomas, J., dissenting).

251. *See id.* at 2226 (Thomas, J., dissenting).

252. *Id.* at 2219.

relationship also face prosecution under the current misappropriation theory.<sup>253</sup> These individuals often lack the professional obligation of trust that traditional fiduciaries have. The test that the Supreme Court has chosen to affirm would expand liability with respect to those individuals outside of traditional fiduciary relationships.<sup>254</sup>

Under *O'Hagan*, a party can be held liable under the misappropriation theory whenever information is improperly taken from a source to which a duty of trust and confidence is owed. In the past, the misappropriation theory has encompassed a broad spectrum of relationships that imposed liability because some type of fiduciary duty was found to exist. These relationships included a psychiatrist and patient,<sup>255</sup> a father and son,<sup>256</sup> and an employer and employee.<sup>257</sup> Other courts, however, found no liability for material, nonpublic information transferred between family members.<sup>258</sup> Whether or not such a duty exists can only be determined by the trier of fact, based on the circumstances of each individual case.<sup>259</sup>

Under *O'Hagan*, the trier of fact must also determine the liability of remote tippees. A remote tippee can be defined as anyone who obtains material, nonpublic information from a tippee beyond the original tip from anyone who owes a duty to the source of the information.<sup>260</sup> Under the lower courts' approach, remote tippees face liability if they trade on information that was originally imparted in breach of a duty. In *Dirks*, remote tippees are held liable if they knew or should have known that there was a breach.<sup>261</sup> In *SEC v. Musella*,<sup>262</sup> the Second Circuit extended this liability to cases premised on the misappropriation theory of Rule 10b-5 liability.<sup>263</sup> The Court in *O'Hagan* did not discuss this theory of remote tippee liability, and therefore, by default, it appears to have affirmed the Second Circuit's approach. Thus, even though the information may pass through many tippees before an individual trades on it, if that individual knew or should have known that there was

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253. See John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, N.Y.L.J., July 31, 1997, at 5.

254. See *id.* Coffee states:

Under § 388 of the Restatement (Second) of Agency, "an agent who acquires confidential information in the course of his employment . . . has a duty . . . to account for any profits made by the use of such information, although this does not harm the principal." The breach of this duty can be described as a "misappropriation," and hence *O'Hagan's* standard for liability can be triggered.

*Id.*

255. See *United States v. Willis*, 737 F. Supp. 269, 271 (S.D.N.Y. 1990).

256. See *United States v. Reed*, 601 F. Supp. 685, 689 (S.D.N.Y. 1985), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

257. See *United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981).

258. See *United States v. Chestman*, 947 F.2d 551, 570-71 (2d Cir. 1991) (en banc).

259. See Coffee, *supra* note 253, at 5 ("The key question should be whether there was a legitimate expectation of confidentiality from the agent on the part of the principal.").

260. See DONALD C. LANGEVOORT, *INSIDER TRADING* § 4.04(3) (1991).

261. See *Dirks v. SEC*, 463 U.S. 646, 660-62 (1983); see also Donald C. Langevoort, *The Demise of Dirks: Shifting Standards for Tipper-Tippee Liability*, *INSIGHTS*, June 1994, at 23 (exploring tipper and tippie liability by looking at *Dirks'* progeny).

262. 678 F. Supp. 1060 (S.D.N.Y. 1988).

263. See *id.* at 1063.

a breach of a duty when the information was imparted to the first tippee, he faces liability. Under this ruling, any breach of a duty, not necessarily one that is confined to the breach of the corporate insider, extends liability. Any time there is a breach of duty, the information obtained by that breach is tainted and anyone who trades upon it can be found liable no matter how far removed they are from the original source.

### *B. The Problem with the O'Hagan Standard*

The misappropriation theory is intended to limit, if not eradicate, trading which is based on information from which traders can gain no-risk profits in connection with the purchase and sale of securities.<sup>264</sup> Under *O'Hagan*, however, virtually any relationship could fall under the scrutiny of the trier of fact. This ambiguity is problematic. If the duty remains unclear, careful investors will be apprehensive about trading on almost any form of information, thereby retarding the efficiency and flow of capital to the market. This could undermine the SEC's intention of protecting free and open trading on the markets. Additionally, this standard is unfair to market actors who cannot know the extent to which they can trade securities legally. Further, the traditionally zealous enforcement efforts of the SEC will create increased litigation since the existence of this duty can only be determined by the trier of fact.

An additional problem raised by the Court's adoption of the misappropriation theory is the apparent adoption of the applications of the theory used in the lower courts. In particular, the approach to remote tippees in the lower courts creates an unfair burden on those traders. It is both impracticable, as well as often impossible, for a remote tippee to investigate every piece of information received prior to trading. Often times, remote tippees are so far removed from the original breach that they do not understand the potential liability. Without a clear limitation on remote tippee liability, the market will be stymied because traders are forced to assume that trading on the information is illegal. As the rule currently stands, securities trading will be inhibited by this potential for limitless liability.

It appears as though the Court has attempted to provide some guidance by reemphasizing Congress' safeguard stating that persons can be criminally prosecuted only if they "willfully" utilized misappropriated information in a securities transaction.<sup>265</sup> Although this was a step in the right direction with respect to protecting market actors, it does not provide sufficient guidance to adequately forewarn criminal liability. Because the rule is uncertain, a dilemma arises where a tippee becomes further removed from the tipper making it more difficult for the tippee to assess whether a duty is owed to the source of the information. Presenting this safeguard as a means to limit liability does not effectively serve its purpose, as

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264. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2209 (1997). The Court in *O'Hagan* premised its support of the misappropriation theory on the basis that it would lead to "honest securities markets" and thus "promote investor confidence." *Id.* at 2210.

265. See *id.* at 2214.

it is virtually impossible for individuals put in this type of position to know whether or not they are liable because no written definitions on such liability exist.

*C. An Illustration of the Problem Under O'Hagan*

While the facts of *O'Hagan* lend themselves to the Court's application of the misappropriation theory, such an application becomes more difficult in cases where the duty to the source of the information is more attenuated. Specifically, the *O'Hagan* test does not allow an individual to determine if his relationship with the source of the information will give rise to liability. Additionally, the test appears to condone limitless potential liability for remote tippees. These two problems within the misappropriation theory can be illustrated in the following manner.

What if it were not *O'Hagan*, a lawyer with a clear duty to both his law firm and law firm's client, who traded on the information? Suppose instead the following fact pattern: A lawyer comes home after work and says to his wife, "ABC has retained my law firm in a possible takeover attempt of XYZ, Inc."<sup>266</sup> The wife finds the information about XYZ, Inc. to be extremely fascinating, but does not trade on that information herself because the lawyer tells his wife that it would be wrong to do so. The next day, the wife sees her daughter and, in passing, tells her that her father is involved in an impending merger with XYZ, Inc. The wife tells the daughter that this information is confidential and that she should not trade on or pass along information about this matter. That same day, the daughter has dinner with her boyfriend and shares the same information she received from her mother regarding the possible takeover of XYZ, Inc. She also warns her boyfriend that it would be wrong to trade securities based on this information. The next morning, the boyfriend calls his broker to buy 1,000 shares of XYZ, Inc. common stock.

The broker, who has been a friend of the boyfriend for years, knows it is unlike him to place such a large order and inquires about the reasons behind his purchase. The boyfriend responds that he has "some definite, some accurate information that XYZ, Inc. is about to be sold at a substantially higher price than its market value."<sup>267</sup> The broker, aware that the boyfriend is dating the daughter of the lawyer, believes the information to be extremely credible and purchases 11,000 shares for himself and his clients.

The test validated by the Court in *O'Hagan* places the responsibility of determining the presence of a fiduciary duty with the trier of fact. If a duty of trust and confidence is present, the trader in question will be found liable; if the duty is not present, then there is no liability. Thus, when looking at the aforementioned hypothetical, the boyfriend's liability under the misappropriation theory would depend upon whether or not a jury determined that the boyfriend-daughter relationship was one under which a fiduciary duty arose in the misappropriation

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266. This hypothetical, while completely fictional, is based on the facts of *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc).

267. This quote comes from the *Chestman* case. See *Chestman*, 947 F.2d at 555. Keith Loeb told Chestman that he had "some definite, some accurate information" that Waldum was about to be sold at a 'substantially higher' price than its market value." *Id.*

theory context. While few juries are likely to find that a simple boyfriend-girlfriend relationship gives rise to such a duty, it is impossible to tell from the hypothetical whether the boyfriend is liable. For example, if the boyfriend were a successful entrepreneur and the girlfriend regularly came to him for financial advice, then liability potentially exists. If the daughter regularly trusted the boyfriend with confidential information, it is possible that a jury could decide that the boyfriend had breached his duty to the daughter by trading on the information with which he was entrusted. Conversely, if they were not boyfriend and girlfriend, but rather a married couple, that fact alone would not necessarily imply a breach of duty. Marriage is not a sufficient enough basis for finding that a duty exists. If the couple never discussed the daughter's family business except for that one time, then it is likely that under the test affirmed in *O'Hagan* the boyfriend would not be found liable. As a result of the broad test accepted by the Court in *O'Hagan* the question of liability remains unclear.

While the SEC may appreciate the broad nature of this test, its burden on the investing public is also clear. Under this test, individuals are forced to speculate on an unknown jury's decision before trading. Not only will they be speculating in the security itself, but also on their personal freedom. Both the inhibiting effects on the marketplace as well as Constitutional problems with the unclear criminal standard are apparent from this example.

Additionally, the decision does not limit liability on remote tippees no matter how attenuated from the original source they are. By failing to discuss the validity of the "known or should have known"<sup>268</sup> standard within the misappropriation theory context, the Court appears to have accepted the lower court's test for remote tippees.<sup>269</sup> In the lower courts, liability for remote tippees was based on the original misappropriation from the source of the information. If the information were misappropriated from its source, any individual who later trades upon that information can be liable for trading. It does not matter how many individuals pass the information or how distanced the trader is from the original source, the initial misappropriation taints all who later trade on it. Not only must a trader risk his money based upon information from which the source is uncertain, but he must also attempt to second-guess whether the trier of fact may some day<sup>270</sup> determine that the information came from an individual who breached his duty.

Certainly, information is a valuable commodity in our society and we should not encourage its theft. But there are other methods of prosecuting the individuals who misappropriate material, nonpublic information.<sup>271</sup> Prosecuting these individuals

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268. See *supra* notes 105-09 and accompanying text.

269. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2207 (1997). It appears as though the Court is furthering a number of the circuits' holdings in its application of derivative liability for "corporate 'outsider[s]' in breach of a duty owed not to a trading party, but to the source of the information." *Id.*

270. An individual can be brought up for section 10(b) liability years after an actual trade and it is up to the trier of fact to determine the legality of this trade, thereby making any trading where the source is uncertain a possible crime.

271. See *United States v. Bryan*, 58 F.3d 933, 952 (4th Cir. 1995). The *Bryan* court stated that there are a number of federal efforts to combat fraud in the marketplace and that the use of section 10(b)

under a theory of liability designed to curb insider trading is not appropriate. Individuals with no connection or duty to the companies in which they trade are not the corporate insiders Congress intended to target with section 10(b) of the Exchange Act.<sup>272</sup>

In our hypothetical, the broker's liability rests on whether he knew or should have known from the nature of the information that it had been obtained at some point in time as the result of a breach of duty to the source of the information. Admittedly, upon further investigation, the broker may have discovered the lawyer's breach of duty. But in the fast-paced and competitive financial marketplace, where decisiveness is essential, evaluating whether information received is material, nonpublic information is not feasible. In the information age, investors are inundated with information from numerous sources<sup>273</sup> and thus evaluating its status under the current standard is not the simple task it was when Rule 10b-5 was formulated by the SEC.<sup>274</sup> It is not practical to conduct extensive investigations of every shred of information that crosses a broker's desk. It is important to note that without investigation, the investor is taking a substantial risk. Taking the time to investigate the source of the boyfriend's information could easily result in a missed opportunity, but could also have prevented a financial misstep if the information were erroneous. Under the *O'Hagan* standard, both no-risk trading, as well as the risk-based trading<sup>275</sup> upon which the integrity of the market rests, are impeded.

#### *D. A More Appropriate Standard*

To deal with the problems resulting from *O'Hagan*, a test that allows for a flexible application of the misappropriation theory, while providing clear guidelines for traders, must be instituted. A more appropriate standard would target risk-free

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should be limited to the scope of liability it was intended to reach. *See id.* The misappropriation theory is not the sole remedy for inappropriate trading under section 10(b) — the mail and wire fraud statutes can also be utilized where the misappropriation theory falls short. *See id.* Additionally, both state law and common law provide remedies where an action falls outside the reach of §10(b) and Rule 10b-5. A number of actions can be brought against securities traders to ensure fairness and propriety in the marketplace. Such actions include "liability for negligence, misappropriation of corporate opportunities or confidential employment information, theft, burglary, and breach of employment contracts." Michael Kenny & Teresa Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 211 (1995).

272. *See supra* notes 20-24 and accompanying text.

273. *See* Kerry Hannon, *Tip or Tout? The Perils of Buying on the Buzz*, U.S. NEWS & WORLD REP., Dec. 9, 1995, at 114.

274. *See supra* note 25 and accompanying text.

275. The riskiness associated with information can be differentiated from the normal risk associated with trading in the securities marketplace. Normal risk associated in the marketplace can be related to a stock's beta. Beta measures a stock's volatility relative to an average risk stock, which by definition has a beta of 1.0. Market risk stems from factors which systematically affect the entire marketplace, including occurrences such as war, inflation, recessions, and high interest rates. The tendency of an individual stock to move with the market constitutes a risk because the market tends to fluctuate and these fluctuations cannot consistently be managed through diversification. *See* EUGENE BRIGHAM & LOIS GAPENSKI, *FINANCIAL MANAGEMENT THEORY AND PRACTICE* 145-46, 164, 211-12, 468, 570, 629 (8th ed. 1997).

trading, but would not inhibit trading that has a factor of risk involved.<sup>276</sup> The following three-pronged test would build upon the *O'Hagan* ruling and would both provide clear guidelines for investors and fight the abuses of insider trading:

(1) An individual who gains access to material, non-public information from the source with a proprietary right to that information as a consequence of performing duties for which consideration is or is normally received shall be liable for his own trades, the trades of the individuals he tips, as well as for the individuals they tip; or

(2) An individual who intentionally and improperly gains access to material, non-public information from a party who has a fiduciary obligation to not reveal/make public that information shall be liable for his own trades, the trades of the individuals he tips, as well as for the individuals they tip; or

(3) An individual with a traditional fiduciary duty, independent of a duty owed to the source with a proprietary right in the information, who trades on or disseminates material, non-public information shall be liable for his own trades, the trades of the individuals he tips, as well as for the individuals they tip.

The first prong of this proposed rule targets misappropriators like in *O'Hagan*, but limits liability only to those who have an assurance as to the accuracy of the information they received. Under this rule, "gaining access to material nonpublic information" would mean obtaining, receiving, or otherwise learning of information in a manner expected by the owner of the information. This would effect both employees of the company as well as independent contractors outside the company who have access to information within the company by virtue of the services they perform. Thus, those who owe a clear duty to the original source may not misappropriate it. Those who do not gain information in the course of their service to the source of the information do not face liability.

Proprietary rights are "[t]hose rights which an owner of property has by virtue of ownership."<sup>277</sup> Under *O'Hagan*, any party who possesses information can be considered its owner, even if they are not the rightful owner.<sup>278</sup> The proposed requirement would only recognize liability when it came from a "source with a proprietary right to the information." Information not acquired through formal means<sup>279</sup> would not meet this requirement. The rationale is that liability should only arise when an individual participates in risk-free trading. When obtaining information from a source other than its rightful owner, a party cannot know whether that information is accurate or not. If he chooses to trade on that information, a risk is being taken.

Gaining this information "as a consequence of performing duties for which consideration is or is normally received" is the next requirement under this prong. Under *O'Hagan*, a duty can extend to any relationship. Under the proposed

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276. See *supra* note 275.

277. BLACK'S LAW DICTIONARY 848 (6th ed. 1990).

278. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2207-08 (1997).

279. A company may generate itself, purchase from another, or contract a third party to create the information in question.



requirement that consideration is or is normally received for the duties performed, a clear line of demarcation between those who have a duty and those who do not is created. Thus, those that receive material, nonpublic information in the course of performing their duties for an employer or contractor are not free to use that information for personal gain. Additionally, those who gain access to information by performing duties for which individuals normally receive consideration will be included. "Normally" in this definition would be a societal standard rather than one based on the individual circumstances. Therefore, performance of a service or duty for which the average, reasonable person would expect to be compensated will meet this requirement. This prevents a lawyer working pro bono from legally misappropriating from his client. At the same time, those who receive information from parties to which they do not have an economic connection, or one that would not normally involve an economic benefit, do not face liability. The rationale behind this distinction is simply that when an individual works for or with a company, he is generally certain that the information the company imparts to him will be truthful. He could not do his job properly without that assurance. Those that perform duties for free have a similar assurance of truthfulness since the individuals they are helping must still give them accurate information to perform their duties. But parties who lack this type of connection when sharing information, have no similar assurance of truthfulness. A party who trades on information received without this assurance of truthfulness is undertaking a risk when he trades on it.<sup>280</sup>

Under this standard, an individual is liable for his own trades and the trades of the people he tips, or the people they subsequently tip.<sup>281</sup> Since liability under *O'Hagan* arises from the source of the information, any relationship, no matter how distant from the original source, can be the basis for liability. The *O'Hagan* standard strays from its purpose of preventing risk-free trading. The *O'Hagan* standard would find liability for trades made on information of which the trader has no assurance of accuracy.

Under the proposed prong, liability attaches when the individual falling within the scope of the rule trades or tips. This requirement places responsibility on a tipper rather than the tippee. The reason for this distinction is that it makes more sense to punish the one who improperly communicates than it does to punish one who trades

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280. Note that in this rule the person who gives out the information still faces the liability for the improper communication. The trader who takes a risk will no longer face prosecution.

281. This standard would protect the mutual fund managers, pension fund administrators, and other institutional investors that come in contact with selective disclosures made by the issuer. Often companies make such disclosures in order to maintain good working relationships with large institutional investors. These disclosures are often material and nonpublic. Thus, the institutional investors run a risk of assuming Rule 10b-5 liability when they trade on this information. This is especially true in situations where the source of the information is unknown or unclear. This standard will protect these investors by only holding liable the one who speaks. See Harvey L. Pitt & Karl A. Groskaufmanis, *The Supreme Court Has Upheld the Misappropriation Theory, But How Far the SEC Will Take the Ruling is Anything But Clear*, NAT'L L.J., Aug. 4, 1997, at B4 (col. 1) ("[The] legal uncertainties [of the *O'Hagan* decision] provide scant comfort to mutual fund managers, pension fund administrators and other institutional investors, who have little desire to sacrifice their resources and good names to help the SEC frame legal standards through the enforcement process.").

on information from an unknown or uncertain source. The original tipper will face liability if anyone further down that chain trades on information he improperly imparted.<sup>282</sup> The additional tippees, however, will not face liability, as they are sufficiently distant from the source of the information. As the source becomes more attenuated, risk enters into the equation. Since Congress' intention is to limit only risk-free trades, those further down the chain should not face liability for taking action that Congress did not intend to limit. This is in accordance with the *O'Hagan* rationale of holding people liable for breaching their duty to the source of the information. However, under the new test, the one who breaches is the one who will be held liable. This would also serve as a deterrent to those with access to material, nonpublic information. By holding one liable for tipping under these circumstances, the integrity of the market will be more secure.

The second prong applies to individuals to whom the source with the proprietary right in the information did not intend to give access to the information. It would apply to parties who "intentionally and improperly gain access to material, nonpublic information" from a source with a proprietary right. This can be distinguished from intentionally and improperly obtaining the information from a non-proprietary source. The rationale behind this distinction is that without the assurance of truthfulness one has when obtaining from a proprietary source, obtaining from any third party carries sufficient risk to justify freedom from liability under Rule 10b-5.<sup>283</sup>

Under this prong, the information must be obtained "from a party who has a fiduciary obligation to not reveal/make public that information." The purpose of this requirement is to inhibit trading on information that is more likely to be accurate because of the relationship between the owner and the source. Information that does not meet this requirement does not carry the same assurance of accuracy as does information shared between fiduciaries.<sup>284</sup>

This prong requires the person to trade on the information or to pass it to an individual who trades. As in prong one, liability attaches when the individual falling within the scope of the rule trades or tips. Whereas his tippees would not be liable for their trades, the tipper would face prosecution for each tippee who trades.

The third prong involves those "with a traditional fiduciary duty" to the individual who shares the material, nonpublic information. This would cover the instance of a doctor-patient relationship such as that established in *Willis*<sup>285</sup> and will not find a fiduciary duty in a normal family relationship such as that in the *Chestman*

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282. It serves to attach liability to the one who is the original breacher of the material, nonpublic information. The application of liability to the person with the duty to the proprietary source stemming from trading by a remote tippee will ultimately create a strong incentive for confidentiality in the face of information that is not meant to extend beyond the four walls of the proprietary source.

283. Of course, intentionally improperly obtaining information from a non-proprietary source carries with it other possible causes of action under state law. See *supra* note 271.

284. There are other causes of action that can be brought against an individual who steals valuable information from an individual where there is no fiduciary duty. But the securities laws are designed to combat risk-free trading, not theft of information.

285. *United States v. Willis*, 778 F. Supp. 205 (S.D.N.Y. 1991).

case.<sup>286</sup> This prong brings greater certainty as to which relationships will be covered by limiting it to only the traditional fiduciary duties.<sup>287</sup> The fiduciaries have an obligation to keep the information they receive from their clients confidential.<sup>288</sup> Unlike the standard in *O'Hagan*, which allows any relationship to qualify as a fiduciary relationship, this test would limit these relationships to those that have been traditionally recognized by the courts.<sup>289</sup>

This prong encompasses a duty that is "independent of a duty owed to the source with a proprietary right to the information." Individuals have a right to seek the counsel of attorneys, doctors, and priests that are not associated with the companies for which they work. In order for these professionals to serve their clients properly, they must have full disclosure of the pertinent facts surrounding the situation of those who seek their counsel. Such disclosure has traditionally been recognized by the Court as confidential because without this confidentiality, traditional fiduciaries would not be able to effectively perform their job.

This prong requires the person to trade on the information or to pass it to an individual who trades. As in prongs one and two, liability attaches when the individual falling within the scope of the rule trades or tips. Whereas his tippees would not be liable for their trades, the tipper would face prosecution for each tippee who trades.

It is important to note that, under this proposal, tippees do not face derivative liability. This differs from both the classical theory of liability as well as the current standard under *O'Hagan*. Essentially, derivative liability allows prosecution of traders rather than those who have tipped them. This proposal to change that is based upon two rationales. First, unlike classical insider trading, individuals prosecuted under the misappropriation theory are corporate outsiders. The basis for derivative liability in the classical theory is that the responsibility of the tipper to the shareholders is imputed to the tippees. The misappropriation theory addresses outsiders who have no obligation to the shareholders of the corporation whose stock is being traded. It seems illogical to impute a duty to a tippee when the tipper of the information did not have a duty to the shareholders of the company whose securities were traded in the first place. Second, by placing liability on the tipper's shoulders, this rule would provide strong motivation for individuals who have access to material, nonpublic information not to reveal it to others. By encouraging individuals not to share information, there is less likelihood that risk-free trades will occur in the marketplace. If the SEC were to "look who's talking" when assessing liability, they would have greater success in their efforts to maintain the integrity in the securities marketplace.

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286. *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc).

287. Examples of traditional fiduciaries include those relations existing between attorney and client, principal and agent, and executor and heir. It is the highest standard of duty implied by law. *See BLACK'S LAW DICTIONARY* 625-26 (6th ed. 1990).

288. Courts already recognize these traditional fiduciary duties as confidential relationships.

289. *See GRAHAM C. LILLY, AN INTRODUCTION TO THE LAW OF EVIDENCE* § 9.1 (3rd ed. 1996).

Satisfying any one of these prongs would be sufficient to find a Rule 10b-5 violation for each improper trade. If a trade results from a tip that satisfies more than one prong of this test, the tipper in question will only face one Rule 10b-5 liability cause of action. The prongs of this test are not meant to give cumulative causes of action. Rather, this test simply delineates all appropriate means of finding liability under the misappropriation theory.

#### *E. Application of the New Standard*

Returning to our original hypothetical,<sup>290</sup> the liability of the parties is now clear. Applying the three-prong test to the lawyer, we can see that the lawyer "has gained access to material, nonpublic information." As a lawyer representing a client, learning about the client's situation is both expected and appropriate. In a situation where a client retains a law firm, any information imparted to one lawyer in the firm is imputed to all lawyers.<sup>291</sup> Even if the lawyer were not directly involved with the representation of the client, he would still meet this requirement.

Next, we must determine if he gained this information "as a consequence of performing duties for which consideration is or is normally received." An attorney representing a client would meet this test. Even if the firm's representation had been pro bono, this would be sufficient to meet this test since it is the type of service for which consideration is normally received. Similarly, as above, even if a lawyer is not directly involved in the representation of the client, just as the information the client imparts is imputed to the firm, so too would be the funds paid to the firm. The attorneys representing ABC require accurate information to fulfill their duties to their clients, therefore there is an expectation that the information they receive from their client will be accurate.

To find liability, the information must be received "from the source with a proprietary right to that information." The lawyer's law firm obtained this information from ABC, which is the information's rightful owner. Thus this information came from a source with a proprietary right. Again, by obtaining information from the rightful owner, the lawyer has a strong assurance that the information is accurate.

Based on the test to this point, we can see that the lawyer has obtained accurate information from the owner of said information in the course of performing his duties for the information's owner. In this situation, trading on this information would be risk-free and therefore, trading on it would compromise the integrity of the market.

Therefore, the lawyer "shall be liable for his own trades, the trades of the individuals he tips, as well as for the individuals they tip." In the hypothetical, the lawyer did not trade himself, nor did his wife, who he directly tipped, trade on the information. The boyfriend and the broker, however, both traded on the information and both of these remote tippees can be linked back to the lawyer's tip. As

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290. See *supra* notes 266-67 and accompanying text.

291. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.10(a) (1983); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 5-105(d) (1980). The rule cited here is the imputed disqualification rule and is cited for analogy.

discussed below, the boyfriend and the broker undertook trades that had a significant element of risk and should not face liability. The lawyer, however, by tipping information that he knew was accurate does face liability for the trades of the boyfriend and the broker. This is because his action compromises the integrity of the market. For this reason, anyone that releases material, nonpublic information with an assurance of accuracy, under this test, should be liable for the damage they cause the securities marketplace. By satisfying the first prong of this test, the lawyer has met the standard for liability and thus would be in violation for both the trades of the boyfriend and the broker.

By validating the misappropriation theory, the *O'Hagan* Court appears to have accepted the lower courts' holdings that a variety of relationships can be the basis for liability.<sup>292</sup> In the proposed test, those relationships from which liability can stem are clear. In the hypothetical, the boyfriend fails the first prong because he is not performing duties. In the way the hypothetical is presented, the boyfriend would also fail the second prong because he did not improperly obtain the material nonpublic information. If the facts were different, however, the boyfriend could face liability under the second prong. Consider this change in facts: Instead of receiving the information freely from the daughter, what if the boyfriend were having dinner with the daughter at the lawyer's home. If, during the meal, he excused himself, went upstairs, and looked through the father's briefcase and discovered this information, then the boyfriend would face liability under the second prong.

An individual under the second prong faces liability when they gain access to and misappropriate material, nonpublic information. Sneaking off and opening the lawyer's briefcase is both intentional and improper. Neither the source with the proprietary right in the information, nor the lawyer, intended for the boyfriend to access the information in this manner. By stealing information, the boyfriend rightfully faces liability under Rule 10b-5.<sup>293</sup>

This information was obtained from "a party who has a fiduciary obligation to not reveal/make public that information." A lawyer has a fiduciary duty to his clients not to reveal the information told to him in confidence. The fiduciary duty under prong two would extend beyond the traditional fiduciary duties that are the focus of prong three. Under prong two, anyone taking information from someone with a duty to maintain a confidential relationship could face liability. While this would recognize the broader definition of when a duty is owed, like the duties recognized in *O'Hagan*, this broader concept of duty is only appropriate when there is an intentional and improper taking of the information. The reason for this

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292. The Supreme Court's affirmation of the misappropriation theory serves as an implied affirmation of the lower court's holdings dealing with this issue.

293. See *supra* note 25 and accompanying text. Rule 10b-5 of the Exchange Act, 17 C.F.R. § 240.10b-5(b) (1997), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails or of any national securities exchange...to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

*Id.*

distinction is the fact that the individual is purposefully committing a wrongful act and therefore a stricter standard should apply.<sup>294</sup>

Under prong two, the party is liable for "his own trades, the trades of the individuals he tips, as well as for the individuals they tip." Again, under this test, the individual who either trades on or releases accurate material, nonpublic information causes damage to the securities marketplace and thereby should be liable for his trades, the trades of those he tips, or one of their tippees. Tippees further down the chain do not face liability because of the risk involved in their trading.<sup>295</sup> They do not have the same assurance of accuracy, as does the boyfriend. The boyfriend is the only one who knows that trading on the information is risk-free.

The broker in the hypothetical would fail to meet the standard in the third prong of the proposed test. This is because he is not an individual with a traditional fiduciary duty<sup>296</sup> to the source of the information, which, in this case, would be the boyfriend. If the facts were different however, and the broker was a psychiatrist, the result would be different. Had the boyfriend gone to the psychiatrist for help and in the course of the professional relationship told the psychiatrist he felt guilty for stealing the information, and then the psychiatrist traded on the information, the psychiatrist would face liability under the third prong. This third prong is designed to prevent those who have a legal obligation to act for the benefit of another from misappropriating information they learn within the scope of their fiduciary relationship.

The psychiatrist would meet the test of "an individual with a traditional fiduciary duty." A fiduciary duty "is the highest standard of duty implied by law."<sup>297</sup> In a fiduciary relationship, both the principal expects and the fiduciary represents that the communications made within that relationship will remain confidential. For example, the rules of evidence recognize that the benefit to society of keeping these communications confidential outweighs the loss of making these communications undiscoverable. The proposed test recognizes the benefits to society of fiduciary relationships and punishes those who take advantage of confidential communications within this context. Further, communications within fiduciary relationships have a strong assurance of accuracy since the party in a position of trust is expected to maintain the confidences of the relationship. Thus, a misappropriating fiduciary realizes that trading on the information received within the fiduciary relationship is risk-free trading. A psychiatrist cannot do his job without obtaining truthful

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294. The Court also recognizes that a higher standard is needed because there is criminal liability involved. See *O'Hagan*, 117 S. Ct. at 2214. The Court applies the stricter scienter standard and therefore, by analogy, willfully committing a wrongful act would also require a stricter standard. *Id.*; see also *supra* note 265 and accompanying text (discussing safeguards for criminal liability the Court emphasized in *O'Hagan* decision).

295. The further removed one is from the source, the more risk associated with trading. The source from which the information came cannot be determined. Additionally, there is doubt with respect to accuracy, and therefore, there is a significant amount of risk involved.

296. See *supra* note 287.

297. BLACK'S LAW DICTIONARY 432 (6th ed. 1990).

information from his patient. By trading on this information, the psychiatrist has breached his obligation to his patient and should face liability for this breach.

This traditional fiduciary duty is "independent of a duty owed to the source with a proprietary right in the information." In the hypothetical, the boyfriend would not have a duty to the law firm from which he stole the information. That, however, is not relevant when a traditional fiduciary duty (psychiatrist-patient) is being breached. Since the confidential nature of fiduciary relationships assures accuracy of information, trades resulting from breaches of this duty threaten the integrity of the marketplace. By virtue of his duty to the boyfriend, the psychiatrist has gained access to information, which he knows to be accurate and then traded upon it. Even though the boyfriend did not have a proprietary right in the information, within the context of the fiduciary relationship there is sufficient assurance of accuracy such that trading on this type of information is inappropriate.

The traditional fiduciary is liable for "his own trades, the trades of the individuals he tips, as well as for the individuals they tip." Under the third prong, once again, the individual who either trades on or releases accurate material, nonpublic information causes damage to the securities marketplace and thereby should be liable for his trades, the trades of those he tips, or the trades of their tippees. The psychiatrist, knowing that the information is accurate as a result of its source, should be liable and no other trader would face derivative liability.

Even though the mother and daughter are both tippers, they do not face liability. The obligation is on the lawyer and not the person who he tips. Neither the mother nor the daughter breached a traditional fiduciary obligation or a fiduciary duty owed to the proprietary source of the information. The one who breaches the duty is liable for any and all trades of any person he tips or any person tipped because of his breach.

Under the new standard, the relationships that give rise to liability are clear. Individuals will know when they are acting appropriately and when they are not acting appropriately, and will be able to regulate their trades accordingly. Additionally, the new standard places the burden of liability on the tipper rather than the tippee. This should provide a strong motivation to prevent the release of material, nonpublic information into the marketplace. Thus, the standard accomplishes both the goal of making criminal liability clear and deterring the release of material nonpublic information in the marketplace. By clearing up liability under the misappropriation theory, this standard would better serve the SEC in its efforts to prevent risk-free trading in the securities arena.

## *VI. Conclusion*

Liability under the misappropriation theory is designed to prevent fraud in the securities marketplace. The misappropriation theory, however, is not meant to govern the "corporate universe."<sup>298</sup> There are many other state actions which cover the crimes to which the lower courts have applied the misappropriation theory. By

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298. *United States v. Chestman*, 947 F.2d 551, 567 (2d Cir. 1991) (en banc).

expanding the misappropriation theory to an indefinite scope, it circumvents the purpose of section 10(b) and Rule 10b-5. Worse, it makes criminal liability unpredictable, which contravenes the protections afforded under the Constitution. The new proposed test should bring certainty to an uncertain rule. By clearly delineating criminal liability, individuals can regulate their behavior accordingly.



